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2001

## Detailed Comments on the U.S. General Accounting Office's May 4, 2001 Exposure Draft

Arthur Siegel

Independence Standards Board

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July 2001

Government Auditing Standards Comment  
Independence Exposure Draft  
U.S. General Accounting Office  
Room 5X16 (FMA)  
441 G Street, NW  
Washington, DC 20548

Comments on May 4, 2001 Exposure Draft on Auditor  
Independence

The staff of the Independence Standards Board is pleased to have the opportunity to comment on the GAO's proposed changes to *Government Auditing Standards* relating to auditor independence. Our comments reflect solely the views of the ISB staff, and do not purport to represent the views of the Board or of any individual Board members.

We agree that the Exposure Draft is a significant improvement over the April 2000 "Preliminary Views." However, we believe that, as important as it is, auditor independence in the context of *Government Auditing Standards* does not warrant a separate full body of knowledge. Rather, we suggest accepting the recent SEC and ISB rules, which have gone through extensive due process, and supplementing them as appropriate for the unique environment of governmental auditing (e.g., for "organizational" considerations). If adopted, your rules should clearly discuss this approach and, where your rules differ, the reasoning for those differences. This "conform and supplement" approach would minimize the difficulties of the currently proposed approach. These difficulties include the need for: (a) users and preparers of audited information to understand these differences in the independence rules for what appear to be similar circumstances, (b) you to maintain and interpret a complete set of rules, and (c) auditors to keep current with another separate set of rules and interpretations which would involve significant costs to the firms without compensating benefits. For your information, we have made a similar recommendation to the AICPA.

Our detailed comments on the Exposure Draft are attached.

If you would like to discuss any of our comments, please contact us.

Sincerely,

Arthur Siegel  
Executive Director

Attachment

Independence Standards Board

Detailed Comments on the U.S. General Accounting Office's  
May 4, 2001 Exposure Draft

3.11 In our draft “Conceptual Framework for Auditor Independence,” we have tentatively defined “auditor independence” as:

both (a) independence of mind – freedom from the effects of threats to auditor independence that would be sufficient to compromise an auditor’s objectivity and (b) independence in appearance – avoidance of activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind.

We believe the use of a common definition would be very helpful to users of audit reports, auditors, and regulatory agencies.

Beyond just the benefits of common professional usage, there are specific reasons for changing your proposed second general standard. Specifically:

“free...from...impairments...” implies an absoluteness beyond what is either necessary or attainable in practice. In addition, “free...in fact” implies an objectively determinable matter which is not consistent with much of auditor independence literature, which necessarily deals with feelings and beliefs. Hence, our use of the term “independence of mind.”

3.12 The restriction in this paragraph applies to “independence of mind,” but seems to omit the important “appearance” aspect of the definition.

3.13 This paragraph also lacks specific reference to perceptions of independence. Furthermore, the second sentence of the paragraph refers to a footnote describing the information that should be reported in the scope section of the auditor’s report if the auditor’s

independence is impaired. Because this important requirement needs additional emphasis, we recommend that you incorporate it into the body of the rule, and that the required wording explicitly state “we are not independent” (similarly to the AICPA’s SSARS-1 paragraph 22 requirement for compilations). We do not believe that disclosure of “any compensating actions taken to minimize the impairment” should be required or permitted. If the auditor still is not independent after the “compensating actions,” then disclosure of them will mislead users of the audit report.

3.15 The proposed requirements on using the work of a specialist appear to be more restrictive than those of related AICPA requirements at AU 336.10-.11. We presume those additional requirements are intended; it would be informative if the final document articulates the reasons why you believe they are necessary. In addition, the proposal requires a more strict treatment for a specialist’s impairment of independence of mind than of appearance. If the specialist’s independence is impaired in appearance, is that sufficiently less important than the specialist’s impairment of independence of mind, so as to result in a different conclusion?

3.16-.19 “Personal Impairments” – We believe this important section is unclear in a number of substantive ways. If these concerns are not addressed by adopting SEC/ISB rules (which would have the added benefit of specifically addressing legal services and internal audit services), we urge that the following concerns be addressed:

A. The section is entitled “Personal Impairments,” and yet it includes an unclear and unrelated collection of selected impairments for “individual” auditors and for “audit organizations.” Activities and relationships of both individuals and firms/audit organizations (e.g., financial interests and employment, and firm investments and non-audit services, respectively) can compromise independence. To provide effective and helpful guidance, the requirements for individuals and audit organizations should be distinguished and clarified.

- B. When these rules are intended to place restrictions on individual auditors (as opposed to their audit organizations), they do not specify which individuals they restrict. Are they intended to restrict those in a position to influence the attest work, only individuals on the attest engagement, all individuals in the audit organization, or whom?
- C. While 3.14 and footnote 2 require “public accountants” additionally to follow AICPA (and state board) independence rules, which cover numerous areas not addressed in these rules, it seems that auditors employed by the government are not so restricted. In any case, the list of restrictions outside of the “public accountant” rules is incomplete. A review of SEC/AICPA literature should be performed to add major categories presently omitted, such as individuals’ family relationships and audit organization business relationships with the audited organization.
- D. Editorial suggestions –
1. 3.17c. As proposed, appraisal materiality appears to be based only on individual results (engagements?) – “of any valuation or appraisal.” We believe another test should be applied against the aggregate of all such engagements.
  2. 3.17d. This requirement seems to be directed to actuarial services for insurance matters and if that is the intent, it should be stated. If not, this paragraph needs to be reconciled with 3.17c.
  3. 3.17e. We suggest this item start out: “For example, the audit organization’s independence would be impaired if...”

3.19 Regarding “inadvertent violations,” your proposal differs in a number of respects from the related SEC rule at Regulation S-X, 2-01 (d). For example:

- A. Did you intend to exempt inadvertent violations of the audit organization, as well as of individuals?

- B. Should you specify that “inadvertent” only covers violations of the rules of which neither the individual nor the audit organization knew?
- C. A mitigating procedure is listed that “(1) the audit organization promptly removes the auditor from the assignment.” Can the auditor return after the violation is corrected?

3.20 “External Impairments” –We believe that these matters are more properly classified as restrictions on the scope of the audit, rather than as “independence” issues.

3.24b. Shouldn’t this preclude a government audit organization from being considered independent when auditing the same legislative body that appointed it?

3.25b. We agree with this requirement, but would add a requirement for the auditor to issue a report to the legislative body either agreeing with the reasons reported by the head of the agency or describing why he or she disagrees. This is similar to the SEC’s requirement when an auditor is terminated or resigns.

3.25f. We would add “compensation and promotion” to the list of protections.

3.27a. We suggest additions so that the requirement would read “is accountable directly to the head or deputy head, or to the governing board, commission or similar entity, of the government entity.”

3.30 ISB Standard No. 1, “Independence Discussions with Audit Committees,” mandates a discussion of auditor independence between the auditor and the senior governance body of the audited entity. We recommend including in your guidance a similar idea, tailored to your environment.

Other –

It is not always clear whether the rule restrictions on the auditor apply at the level of the entity, or just of the activity or program.

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